eLign

2006 NUMBER 1

A RAYLIGN **STAYIN' ALIGNED** FEATURE PUBLICATION

A CIRCUS "NET" — Costs of hedge funds vs. long-only alternatives

Welcome to the hedge fund three-ringed circus, featuring absolute returns, less volatility and low correlations. The greatest show on earth!

Many hedge funds have been sold to provide "equity-like" returns with less risk and low-correlation to traditional asset categories (fixed income and long-only equities). Absolute returns, less volatility and low correlations always seem to travel together. Generally, to discuss returns requires a discussion of relative volatility and correlations, and vice versa. However, for the long-term investor, "net" returns are worth a more isolated evaluation. This analysis takes "absolute returns" out on the road by itself.

There has been a lot written on the subject of "net" investment results after considering fees, taxes and trading costs. However, there are few places that show true "apples to apples" comparisons of "net" results across a variety of investment strategies; namely, index funds, active equity (long only), hedge funds and fund of hedge funds. This analysis is particularly relevant to the taxable investor, and is relevant to all investors in an anticipated lower return environment.

Detrimental impact of costs & fees on investment returns

	Fund of hedge funds	Direct hedge funds	Active equity	Passive equity
Comparable gross returns *(to achieve same "net" result)*	**15.8%**	**13.3%**	**9.3%**	**8.0%**
Manager/ETF Management Fee	1.5%	1.5%	1.0%	0.2%
Manager Incentive Fee	2.9%	2.4%	-	-
Fund of hedge funds Mgmt Fee	1.0%	-	-	-
Fund of hedge fund Incentive	1.0%	-	-	-
Taxes (1)	2.8%	2.8%	1.7%	1.2%
Total costs (4)	**9.2%**	**6.7%**	**2.7%**	**1.4%**
Net return	6.6%	6.6%	6.6%	6.6%
Difference vs. passive	7.9%	5.3%	1.3%	-
Costs as % of gross return	58.4%	50.3%	28.9%	17.1%
Assumptions				
Manager/ETF Management Fee	1.5%	1.5%	1.0%	0.2%
Manager Incentive Fee	20.0%	20.0%	-	-
Fund of hedge funds Mgmt Fee	1.0%	-	-	-
Fund of hedge funds Incentive	10.0%	-	-	-
% of return realized/income (2)	100.0%	100.0%	67.7%	50.0%
Tax rate (3)	30.0%	30.0%	30.0%	30.0%

Notes:
(1) taxes conservatively calculated as "comparable gross return" less costs multiplied by realized/income by tax rate
(2) many hedge funds have high turnover approaches, resulting in high realized short term gains at ordinary income tax rates
(3) many active and passive managers with low turnover avoid short-term gains and therefore defer taxes for lower rates
(4) analysis does not include trading costs, which will add significant cost hurdles for more actively traded hedge fund strategies

A circus "net" — Costs of hedge funds vs. long-only alternatives

The definition of "net" in this analysis is investment returns less management fees, incentive fees, and taxes (we are being considerate by not including trading costs, which by the way, can be significant for high turnover strategies like hedge funds).

Whereas hedge funds have been favored recently to protect capital in negative periods, the "price" of this protection is significant. Add the fact that it is extremely difficult to determine and access winning strategies in advance of strong results, and the exercise of allocating

> In the case of FUND OF HEDGE FUNDS, the investor is asking for heroic results from manager selection, strategy allocation and the hedge fund managers themselves.

capital to hedge funds becomes a very expensive way to sleep comfortably at night. For me, what keeps me up at night is overly compensating my portfolio manager friends (performance), Wall Street Managing Directors (trading) and government coffers (taxes). But humans being humans, it seems that many investors are willing to "ensure" limiting losses (and be accepted at social settings) for the sake of lesser long-term net results. The behavioral psychologists would have a field day with this one.

A sobering stream of logic goes as follows: if 5% of the 8,000 hedge fund managers can actually deliver on the required returns to overcome fees and taxes over the long-term (this is being very generous), then why do the other 7,600 hedge fund managers exist? Good question. There is similar precedence in the mutual fund and separate account long-only arena. In the case of a fund of hedge funds, the investor is asking heroic results from manager selection, strategy allocation and the hedge fund managers themselves — all three competencies have proven to have limited sustainability over extended periods of time, to say the least. Not to mention that the majority of our leading list of 400 hedge fund managers are closed to new business because they realize the negative impact of managing too much capital. And frankly, they don't need your money.

There can be a role for hedge funds as part of a diversified, global, tax-aware investment program, but for most investors, particularly taxable ones, it needs to be well considered. This analysis suggests that the return hurdle for hedge funds and fund of hedge funds needs to be better understood, regardless of volatility and correlation benefits.

RAYLIGN

Raylign Advisory LLC

35 Mason Street, 4th floor
Greenwich, Connecticut 06830 USA
(203) 622-4658 tel
www.raylign.com

eLigns are published periodically to help families safely negotiate the big bends in the road, the ones that really matter.